Baker & McKenzie LLP
815 Connecticut Avenue, NW
Washington, DC 20006-4078, USA

Tel: +1 202 452 7000
Fax: +1 202 452 7074
www.bakermckenzie.com

February 5, 2013

Ms. Marlies de Ruiter
Head, Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD Centre for Tax Policy and Administration
2, rue André Pascal
75775 Paris
FRANCE

RE: **Recommendations of the Treaty Policy Working Group on *Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)***

Dear Ms. de Ruiter:

We are writing to offer the recommendations of the Treaty Policy Working Group on the OECD's revised public discussion draft of October 19, 2012, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)*. The Treaty Policy Working Group is an association of large global companies based throughout the world that represent a broad spectrum of sectors. We have been working together since 2005 to analyze and address tax policy and administration concerns relating to permanent establishment, transfer pricing, and other issues.

General Recommendations

TPWG members welcomed this OECD initiative to address common questions and known points of disagreement by clarifying the OECD Commentary on permanent establishments, given the recent increase in controversies regarding these issues. A broad international consensus on the permanent establishment threshold is critically important to our members as they seek to avoid double taxation and taxation not in accordance with applicable conventions and the associated uncertainty and controversy. Clear guidance on the permanent establishment threshold is particularly important to TPWG members as they seek to satisfy their tax obligations, because it often determines whether a taxpayer must file returns in a particular jurisdiction and pay income tax on a net basis in addition to applicable taxes at source. An unclear permanent establishment threshold can result years later in very substantial, unexpected assessments, which taxpayers and treaty partners then have no alternative but to contest.

The issues selected by Working Group 10 of Working Party 1 for resolution in this project included the most important practical issues that business

commenters had identified. The Working Group and Working Party have proposed many useful clarifications. However, as noted in our earlier comments, the initial discussion draft also left ambiguities that promised to give rise to continuing or even increased controversy. We were disappointed to see that these ambiguities generally remain in the revised discussion draft. We were also surprised that a number of the current practical issues identified by business throughout the project have simply gone unaddressed, often on the basis that the current Commentary provides adequate guidance. Such results are not typical of the OECD's usual consensus-building efforts.

We understand that these shortcomings were due primarily to the inability of the Delegates to reach agreement on many of the major issues. In addition, it was clear even at the September 2012 consultation on this project that some Delegates were reluctant to agree to general principles that might restrict their ability to find a permanent establishment on the facts of some future cases. Others expressed a reluctance to draw "bright lines" that could permit taxpayers to conduct a specified level of activity without creating a permanent establishment, because taxpayers might conduct such activity "up to the line" (*i.e.*, to the full extent allowed).

Our sense is that the difficulty may be that some are viewing the permanent establishment threshold less as a threshold for net-basis income taxation than as an anti-"abuse" measure or even as a tool for increasing taxation at source. We believe that such views undercut the ability of the permanent establishment concept to perform its intended role, which is to facilitate cross-border trade and investment by permitting agreed minimum levels of business activity to be conducted in a jurisdiction without local income tax reporting burdens. Application of the permanent establishment threshold in accordance with its intent does not constitute tax "avoidance" or base erosion or raise other tax compliance concerns. The permanent establishment threshold is a fundamental part of the agreed overall balance established by treaties to facilitate trade and investment, and its proper application is critical to the intended operation and orderly administration of the international treaty network.

Any view of the permanent establishment threshold as creating undesirable opportunities for tax planning also diverges from the business community's experience in practice of the permanent establishment threshold as an ill-defined area of the law that has become a major source of risk and controversy. In any event, we would note that the permanent establishment threshold is policed by the anti-fragmentation rules and other safeguards already provided in the Model Tax Convention and Commentary, which operate well to address identified concerns.

As stakeholders seeking to comply with their tax obligations around the world, TPWG members find the failure of this project to produce agreement on many important issues under the existing Model Tax Convention and Commentary disconcerting. We are concerned that this portends more controversies among OECD member countries and others and that the proposed new OECD guidance will not provide an adequate principled basis for resolution of those disputes. If the issue is that current permanent establishment provisions are now seen by tax administrations as too restrictive in some respects, we submit that such concerns should be considered separately

as matters of policy rather than through reinterpretation of existing guidance. Any agreed change should be implemented through prospective amendments to OECD and bilateral tax convention texts, to establish a legal basis for the change and avoid controversies regarding use of the Commentary for this purpose. In the meantime, we respectfully urge Delegates to redouble their efforts to draft a clearer set of guidelines for determining under current treaties when a permanent establishment does and, equally importantly, does not exist. This is necessary to facilitate tax compliance and administration and minimize cross-border controversy. It is also essential to preserve the value of OECD guidance in the Model Tax Convention and Commentary as the international standard for treaty interpretation.

Specific Recommendations

Consistent with our general comments above, we would like to offer some specific recommendations for the consideration of Delegates. While we remain concerned about many of the issues noted in our earlier comments on this project, we note the Working Party's request that comments focus on drafting points rather than issues of substance. Accordingly, our recommendations at this stage address only three of the most critical points where the intent appears to be unclear or unsettled or where the proposed additions to the Article 5 Commentary seem inconsistent with Article 5 or with the existing Commentary. The changes suggested below are offered in the hope of inspiring clearer guidance that will minimize interpretive issues and controversies.

1. **When may a foreign enterprise be considered to have a place of business at a location of another enterprise, and when should its presence there be disregarded?**

To determine whether a foreign enterprise has a place of business at the location of a third party that may create a permanent establishment for it under Article 5(1), the current Commentary generally looks, in paragraph 4, to whether the place of business is "at the disposal" of an enterprise. The Commentary indicates that this may be the case where an enterprise using premises owned by another enterprise "has at its constant disposal certain premises or a part thereof owned by the other enterprise." Paragraph 4.2 adds that while no "formal legal right" to use a place is required, the "mere presence" of an enterprise at a location does not necessarily mean that that location is at the disposal of that enterprise. The current Commentary then provides a series of examples that were added in 2003 and continue to be the subject of some debate.

Proposed new Commentary paragraphs 4 and 4.2 retain these provisions but propose some important additions in paragraph 4.2 that attempt to clarify the meaning of the phrase "at the disposal." New paragraph 4.2 states as a central principle that whether a location will be considered to be at the disposal of an enterprise "will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there." New paragraph 4.2 also helpfully confirms a series of other important points, including that:

- The enterprise does not have a location at its disposal if it does not have a right to be present there and does not, in fact, use the location itself;

- Premises owned and used exclusively by service providers do not create a permanent establishment for their customers, for example, where a plant owned and used exclusively by a supplier or contract manufacturer supplies goods produced there for use in the business of the enterprise;

- A location is not at the disposal of the enterprise if its presence there is "so intermittent or incidental" that it cannot be considered a place of business of the enterprise, as where its personnel "have access to" the premises of an associated enterprise, which they "often" visit without working there for "an extended period of time";

- An enterprise that "is allowed to use" a "specific" location and performs its business activities there "on a continuous basis during an extended period of time" will be considered to have that place at its disposal; and

- The preparatory or auxiliary exceptions of Article 5(4) must be taken into account and may preclude the finding of a permanent establishment where applicable.

The meaning of the term "at the disposal of" is an important issue for TPWG members, and we appreciate the efforts of the Working Party and the Working Group to bring more clarity to the interpretation of this expression. We believe that the principles enunciated in new paragraph 4.2 are consistent with the OECD's long-standing interpretation of the permanent establishment threshold. They appropriately confirm that the standard is neither a high bar that requires legal ownership of the premises, nor a low bar that treats the mere availability of or mere presence at a location as sufficient.

Our experience in practice, however, continues to be that tax auditors too often assert the existence of a permanent establishment based on "at the disposal" arguments that are inconsistent with these well-established principles. For example, we regularly encounter arguments that, notwithstanding the mandate of Article 5(7) to the contrary, a foreign enterprise has a permanent establishment at the premises of a local associated enterprise because their control relationship automatically puts the premises of the local enterprise "at the disposal of" the foreign enterprise. Such arguments are sometimes made even in situations where employees of the foreign enterprise are not present at the local premises at all or are present there only occasionally for short periods. Although such assertions do not, in our view, represent a fair reading of the Commentary, their prevalence shows the need to examine very carefully any language to be added to the Commentary to minimize the possibility that it can be interpreted in an unintended way.

We are concerned that the text of new paragraph 4.2 may be vulnerable to misinterpretation in two important respects. The first concern is that, as noted above, paragraph 4.2 introduces new

terminology providing that whether a location is at the disposal of a foreign enterprise depends in part on the foreign enterprise "having the effective power to use that location." A shorter formulation, "power to use," was not well-received at the September 2012 consultation, and the term "effective" was subsequently added to the revised discussion draft, presumably to signal a higher standard. However, there is no discussion of what might constitute an "effective power to use," how long such power to use must be held, or how it may be exercised. We remain concerned, therefore, that some might seek to equate effective power to use with mere presence, on the theory that presence at a location necessarily demonstrates an effective power to use it.

Our second concern about potential misinterpretation of paragraph 4.2 relates to its suggestion that the "extent of the presence" of the enterprise is also relevant to the "at the disposal" determination. This phrase focuses on whether the enterprise is present at the location, without specifying a time or other quantitative threshold. We are concerned that the introduction of this very general reference to presence might be read by some to support a contention that a mere presence for a short period of time would suffice to cause a location to be deemed to be "at the disposal" of the enterprise.

We are concerned about these potential misinterpretations because they might be perceived as eliminating the distinction between the "fixed place of business" permanent establishment provisions of Article 5(1) and the alternative "services PE" provisions of paragraphs 42.11 – 42.48 of the Commentary, which depart from Article 5 of the Model Convention and apply only if added to the text of the applicable bilateral convention. The "services PE" provisions require that the foreign enterprise be present for more than 183 days during the taxable period but do not require that it have a fixed place of business at its disposal. Article 5(1) does not set a specific time threshold for the enterprise's presence but requires a fixed place of business. Therefore, if the "at the disposal" provision of paragraph 4 of the Commentary on Article 5(1) could be read to require only a mere presence, without a fixed place of business or a clear time threshold applied in all instances, a permanent establishment might be found in cases that are not reached even by the "services PE" provisions. This would be an illogical result, because the intended effect of the "services PE" provisions was to deem a PE to exist where none would otherwise be found. The Working Party should take care not to add text to the Commentary that could lend itself to such an incoherent interpretation of Article 5.

To avoid all of these potential misinterpretations, we would recommend that, instead of relying on new, undefined terms, the Working Party replace the proposed reference to "that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there" with familiar terminology that would more clearly express the intention of the "at the disposal" requirement. We continue to believe that "control" would most clearly communicate the intended meaning of the "at the disposal" standard. However, we understand that at least some members of the Working Party are reluctant to rely on the term "control" alone in paragraph 4.2, perhaps due to concerns that it would establish too high a threshold. If these concerns cannot be addressed through more precise drafting, we would recommend that the Working Party consider using one of the

following alternative formulations in paragraph 4.2, to communicate that a foreign enterprise will not be considered to have premises of another enterprise at its disposal unless it:

1. "Either owns or has legal possession of the premises, or controls access to and use of the premises" (adapted from proposed new paragraphs 10.1 and 19); or

2. "Uses the premises, with the ability to exclude others, over an extended period of time to conduct, without limitation, the most important functions of its business" (adapted from existing paragraph 4.5, proposed to be renumbered as paragraph 4.7).

If no consensus on clearer language can be reached, we would prefer that new paragraph 4.2 follow the long-established standard of paragraph 4 for presence at another enterprise's premises, namely, whether the foreign enterprise "has the premises at its constant disposal." In our view, this approach would be less desirable because it would do little to resolve existing issues, but it would at least avoid creating the new issues that seem likely to result from introduction of the new terminology proposed in paragraph 4.2.

On a separate point, we also believe that it would be appropriate for the Working Party to confirm explicitly that the discussion of suppliers and contract manufacturers in paragraph 4.2 also applies to consignment or toll manufacturers. This is consistent with the discussion of the CARCO example in paragraphs 17 and 18 of the revised discussion draft, because the CARCO example clearly involves a consignment or toll manufacturing arrangement under which the foreign enterprise maintains ownership of the raw materials, work-in-process, and final product through the manufacturing process. This clarification would help prevent unintended negative inferences and avoid future controversies. It can be accomplished simply by adding "or a consignment or toll manufacturer" after "supplier or contract-manufacturer" in paragraph 4.2, to confirm that the same conclusion applies equally to a consignment or toll manufacturing arrangement.

2. **When may a third party performing services for a foreign enterprise be considered, as a result of those activities, to be carrying on the business of the foreign enterprise?**

A permanent establishment does not arise under Article 5(1) unless the enterprise is carrying on its business, in whole or in part, through a fixed place of business. The current Commentary acknowledges, in paragraph 10, that the business of the foreign enterprise is carried on "mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel)," including dependent agents, or in some cases through automated equipment. However, neither the current Commentary nor the revised discussion draft discusses directly the critical issue of whether a third party performing services for a foreign enterprise may be considered, for this purpose, to be carrying on the business of the enterprise.

This issue is an important one, because enterprises today commonly decide for strategic business reasons to outsource certain functions, such as manufacturing or other industrial activity, in order

to concentrate on other functions. This often involves independent third parties, but, as many company groups have centralized their functions to realize efficiencies, a particular group entity may also perform certain cross-border services for other entities in the group.

The issue of whose business is being carried on in such situations raises a number of questions. Should the activities of the third party be considered to constitute the carrying on of its own business? Or may the provision of services by a third party create a permanent establishment for its customers on the theory that the third party is thereby carrying on their business? What would be the technical and policy basis for such a result? What criteria should govern the determination? What profits, if any, would be attributable to a permanent establishment that is deemed to be created by the third party's activities? If, as seems likely, the third party is also considered to carry on a business of its own in performing its services, how can the duplicative attribution of profits from those activities be avoided?

Currently, Article 5 attributes the activities of one entity to another only in the case of a dependent agent that has and habitually exercises an authority to conclude contracts in the name of another entity (Article 5(5)), or an entity that carries on business through an agent of independent status operating outside the ordinary course of its business (Article 5(6)). The other provisions of Article 5 do not provide for the attribution of activities from one entity to another.

The revised discussion draft would amend the Article 5 Commentary to attribute activities in ways that are inconsistent with the existing Commentary and with the apparent intent of Article 5. For example, in discussing its proposals to attribute the *presence* of a "subcontractor" for purposes of Article 5(1) and Article 5(3) generally, the revised discussion draft provides the following "Background":

> "48. The Working Party concluded that the implication of paragraph 19 was that the activities of the subcontractors were allocated to the main contractor. It was also noted that it would be fairly unlikely that a main contractor would not have some employees on a construction site and that it would seem strange to have a different result if the main contractor's employees spent only one day on the site.
>
> "49. The Working Party also concluded that the issue was not restricted to construction sites and to paragraph 19 of the Commentary but was in effect related to the more general issue of whether an enterprise can carry on its business through subcontractors and, therefore, to paragraph 10 of the Commentary."

The revised discussion draft thus suggests that attributing the activities of subcontractors is generally appropriate, based on a reading of paragraph 19 as providing for the *activities* of a subcontractor to be "allocated" to the main contractor. Noting in the passive voice the view that the main contractor would likely have some employees on the construction site anyway and that it would seem strange to treat minimal presence differently from no presence, the revised discussion draft concludes that enterprises generally may be regarded as carrying on their

business through their subcontractors under paragraph 19 even where the enterprise has no presence at the location.

Although the discussion appears in a section captioned "Main contractor who subcontracts all aspects of a contract," the revised discussion draft goes on to state that "the issue" is not limited to construction sites and proposes to apply the same approach under paragraph 10 of the Commentary as well. Proposed paragraph 10 uses the term "subcontractors," presumably drawn from current paragraph 19, but neither the current Commentary nor the revised discussion draft defines the term "subcontractors" for this purpose.

The revised discussion draft thus curiously proposes to interpret a treaty provision conditioned explicitly on physical presence at a particular location in a manner that equates no presence with some presence, on the basis that a different interpretation would "seem strange." The revised discussion draft does apparently recognize, however, that this approach would produce inappropriate results in at least some cases where the foreign enterprise has no presence at the location, so it provides exceptions for the premises of suppliers or contract manufacturers (in proposed paragraph 4.2), for other locations at which the foreign enterprise does not have a right to be present and which it does not "use" itself (in proposed paragraph 10.1), and for other limited cases. These exceptions are welcome, but would be more helpful if their scope were stated in more definitive terms than, for example "so intermittent and incidental." In addition, we remain concerned about the general presumption that the activities of a third party should be attributed to its customer and be considered to constitute the carrying on of the customer's business, even where the customer has no presence at the location concerned.

The Working Party clearly recognized that there may be an issue as to whose business a third party is carrying on because it raised that issue in the CARCO example of a subsidiary, SUBCAR, performing contract manufacturing for its parent, CARCO, but did not answer it. The TPWG noted this omission in its comments of February 13, 2012 on the prior discussion draft and requested guidance on the issue of whose business was being conducted. While the revised discussion draft reaches an appropriate conclusion on the example, it unfortunately remains silent on this key issue. It may not be technically necessary to determine whether the subcontractor is carrying on the business of the foreign enterprise if the creation of a permanent establishment is precluded on other grounds, as in the CARCO example. However, the issue is determinative in some cases, including the "small hotel" example in proposed paragraph 10.1 of the Commentary, so it remains an appropriate issue for clarification in the Commentary, especially given that the Working Party has identified it as an issue.

We submit that, in the CARCO case, it should be clear that the business activity being carried on at the manufacturing location is the business of SUBCAR, not of CARCO. It is generally the case that a third party that provides services to an enterprise is carrying on its own business and not the business of the foreign enterprise, even when the business activities of the two entities are integrally related, as is normally the case in an affiliated group where two entities contract with

each other as participants in a single production chain. The revised discussion draft's apparent presumption to the contrary should be reconsidered.

The revised discussion draft does not articulate a technical or policy basis for attributing activities across entities. As noted above, the proposed attribution approach appears to be derived from the provisions of paragraph 19 of the Commentary, which attribute the time spent by a subcontractor on a construction site to a main contractor that is also on the site, solely to address the specific concerns identified in paragraph 18 regarding the Article 5(3) time threshold. However, that provision is very narrow in scope and conspicuously refrains from attributing either the subcontractor's activities or the profits, if any, from those activities to the main contractor. It does not, in our view, provide a clear foundation for the significant changes proposed by the revised discussion draft, which seem fundamentally inconsistent with the provisions of Article 5(1) requiring that an enterprise conduct its own business through a fixed place of business.

The expanded attribution proposed by the revised discussion draft also seems inconsistent with existing provisions of the Commentary, such as paragraphs 42 and 42.23, which correctly indicate that a service provider generally does not carry on the business of the service recipient.

Looking at Article 5 as a whole, the proposed attribution of activities would also seem to render the provisions of Article 5(5) largely irrelevant, as a third party could create a permanent establishment for an enterprise in many cases even without being a dependent agent, having an authority to conclude contracts in the name of the foreign enterprise, or habitually concluding such contracts, and absent any presence of the enterprise itself at the fixed place of business. Could such a result really have been the intent of Article 5(1) and Article 5(3)? Given that attribution of activities from one entity to another is fundamentally in tension with the separate entity accounting principle of taxation, we would suggest that it should occur only in limited exceptional circumstances and on the basis of carefully considered and fully articulated technical and policy considerations.

Finally, the lack of clarity on the profit attribution consequences of attributing activities of one person to another also makes it appropriate for the Working Party to further deliberate the proposed approach, in coordination with Working Party 6, to ensure that the proposed changes to Article 5 do not conflict with the OECD's recent guidance on Article 7.

We request that the revised discussion draft be amended to clarify these issues as follows:

The very broad statement in proposed paragraph 10.1 that an "enterprise may also carry on its business through subcontractors" should be removed pending further consideration. When read together with the statement in proposed paragraph 4.2 suggesting that an enterprise which "performs business activities … at a location" has that location at its disposal, and absent any definition of the term "subcontractors," proposed paragraph 10.1 could be misinterpreted to suggest a third party that performs services for an enterprise generally may create a permanent

establishment for the enterprise. To avoid this, the Commentary should explicitly confirm that a third party generally will not be regarded as carrying on the business of an enterprise for which it is performing services. If the Working Party believes that circumstances exist where a third party should be so regarded, then specific guidance should be proposed to identify those circumstances.

Similarly, we would suggest that the revised discussion draft either articulate the basis for treating the subcontractor as carrying out the business of the foreign enterprise in the "small hotel" example in proposed paragraph 10.1 or delete that example pending further consideration. We believe that its conclusion is inconsistent with the underlying premises of the "manpower company" hotel scenario in paragraph 39 of the revised discussion draft and that the cost plus remuneration of the on-site management company is irrelevant. Absent discussion of the technical and policy grounds for the conclusion drawn in this example, its addition to the Commentary would seem likely to result in confusion and controversy rather than clarification. If the proposed provisions are retained, we request that the Commentary require, in any event, that the additional requirements of proposed paragraph 10.1 be met in order for any third party to create a PE for an enterprise under Article 5(1).

3. <u>When may the presence of a third party at a place of business be attributed to a foreign enterprise</u>?

In our experience, there is often disagreement about whether the presence of a third party conducting its own business at a place of business may be attributed to the foreign enterprise to determine if the foreign enterprise has a permanent establishment there for purposes of Article 5(1). This fundamental question underlies a number of the issues considered in this project but has not yet been addressed with sufficient clarity. In fact, we believe that some of the language proposed by the revised discussion draft could create even more confusion and controversy.

The current Commentary on Article 5(1) generally focuses on whether a place of business is "at the disposal" of the foreign enterprise itself. The Article 5(1) Commentary does not attribute the presence of another enterprise conducting its own business to the foreign enterprise, even in the case of associated enterprises. This is specifically confirmed by paragraph 42 of the Commentary on Article 5(7), added to the Commentary in 2005 in response to the Italian court decision in *Ministry of Finance (Tax Office) v. Philip Morris (GmbH),* Corte Suprema di Cassazione, No. 7682/02 (25 May 2002), which provides that services performed for a foreign enterprise by personnel of an associated enterprise do not create a permanent establishment for the foreign enterprise under Article 5(1) where the services are part of the associated enterprise's own business and are provided at the associated enterprise's own premises. In that situation, paragraph 42 specifies that the associated enterprise's premises are not at the disposal of the foreign enterprise. The revised discussion draft retains the key provisions of paragraphs 10 and 42, with a helpful confirmation in paragraph 10 that, where activities are conducted by dependent agents of the enterprise, they must be conducted at the fixed place of business of the enterprise in order to give rise to a permanent establishment under Article 5(1).

The approach taken under Article 5(3) for building sites and construction or installation projects is currently very different from the approach of Article 5(1). Paragraph 19 of the current Commentary does provide for a limited attribution where a general contractor subcontracts *parts of* the project to subcontractors. In such situations, the time spent by subcontractors at the site is attributed to the general contractor for purposes of determining whether the general contractor has a permanent establishment under Article 5(3). However, this provision does not attribute activities or profits from one enterprise to another.

Under current OECD guidance, the time spent by one entity is attributed to another only in these specific limited circumstances involving building sites and construction or installation projects, where the main contractor is also present to some extent. Paragraph 18 of the Commentary indicates that this attribution provision was included to address specific perceived "abuses" involving the division of a project among associated enterprises to avoid exceeding the twelve-month threshold of Article 5(3). The revised discussion draft suggests, however, that the paragraph 19 exception is provided because the site should be considered to be "at the disposal" of the general contractor. The revised discussion draft then proposes to expand the reach of paragraph 19 to cover even cases where the general contractor is not present at all on the site, because it has subcontracted *all* of the project. Where the general contractor is not there, proposed paragraph 19 does caution that "the general contractor [must] clearly [have] the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during the period." This exception is helpful, but it turns on novel factors that do not otherwise appear in Article 5, its current Commentary, or elsewhere in the revised discussion draft except, as discussed below, in proposed paragraph 10.1.

The revised discussion draft also proposes to change the current Article 5(1) approach by adding a novel rule for subcontractors in a new paragraph 10.1 of the Commentary. The general principle under proposed paragraph 10.1 is that the presence of a subcontractor may be attributed to a foreign enterprise only if the place of business it uses is "at the disposal of" the foreign enterprise "determined on the basis of the guidance in paragraph 4.2." However, in reconsidering whether the Article 5(3) attribution rule of paragraph 19 of the Commentary should apply when all parts of a project are subcontracted, the revised discussion draft proposes the application of such an attribution rule for purposes of Article 5(1) as well. As noted above, in discussing paragraph 19, paragraph 46 of the revised discussion draft asserts that, "[a]s was noted when the issue was discussed by the Working Party, the issue goes beyond the scope of Article 5(3) and raises questions concerning the interpretation of paragraph 10 of the Commentary, which discusses how the business of enterprise *[sic]* is carried on for the purposes of the application of Article 5(1)." This assertion is curious for three reasons: it seeks to extend by Commentary the scope of current paragraph 10, which has long clearly applied only to the conduct by personnel of the enterprise or through automated equipment of the enterprise's own business; it mentions a hypothetical case study used in an IFA discussion but cites no authority or policy rationale for the proposed change; and, unlike most of the revised discussion draft, the

new proposition is stated in the passive voice, without any indication of its source or level of Working Party support. Given the magnitude of this change to a long-standing Commentary text, it would be useful to have a more clearly articulated rationale for the proposal.

The revised discussion draft nonetheless proposes to add new paragraph 10.1 to expand the scope of current paragraph 10 to include "subcontractors, acting alone or together with employees of the enterprise." It specifically states that this approach would not be limited to construction sites (or, presumably, building sites or installation projects), as under new paragraph 19.1. This introduces for the first time the possibility that the presence of an associated enterprise or even an independent third party may be deemed to create a permanent establishment for a foreign enterprise under Article 5(1), even where the foreign enterprise is not itself present there. In apparent recognition of this expansion, new paragraph 10.1 adds that "in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of that site." This exception is, again, useful but perhaps less so than it might otherwise be, given its use of undefined terms such as "clearly" and "effective power."

The revised discussion draft thus proposes to introduce two important changes to the Article 5 permanent establishment threshold by Commentary, without amending the text of the Article. These proposals would represent a significant lowering of the permanent establishment threshold in many cases. They would not merely clarify the current Article 5 Commentary; they would extend Article 5(3)'s limited anti-"abuse" provision to situations previously excluded under Article 5(3) and to permanent establishment determinations under Article 5(1) generally, including situations involving independent third parties. The proposed changes to paragraph 10.1 would also seem difficult to reconcile with the provisions of paragraph 42 of the Commentary. They seem equally difficult to reconcile with the policy conclusion reflected in the "services PE" provision at paragraph 42.23 of the Commentary, which, as indicated by paragraph 42.43 of the Commentary), "clarifies" that "services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual." Thus, even the "services PE" alternative refrains from attributing activities conducted by a local service provider to a foreign enterprise where the enterprise is not closely supervising the manner in which those services are performed. It is difficult to conclude that activities should be attributed to foreign enterprises more broadly.

Given the expansive nature of the proposed changes and the limited scope of the current Working Party 1 project, we respectfully suggest that it would be appropriate to delete proposed new paragraph 10.1 and to amend paragraph 19 to remove the proposed addition of "all or" before "parts of such a project."

If proposed paragraphs 10.1 and 19 are retained, the conditions they suggest for attributing a third party's presence (and apparently its activities) to the enterprise should be stated definitively as the applicable requirements, rather than as examples, to avoid a further lowering of the permanent establishment threshold. It will also be essential for Working Party 1 to work closely with Working Party 6 to determine how profits can be attributed appropriately, particularly where the presence of an independent third party at a location other than the enterprise's premises is considered to create a place of business for the enterprise.

If paragraph 10.1 is retained, it also would be helpful to add as a conforming change to proposed paragraph 4.5 a statement or at least an example confirming that, even where the "preparatory or auxiliary" exceptions of Article 5(4) do not apply, no permanent establishment is created in a contract manufacturing arrangement by reason of the fact that the foreign enterprise has the right to enter upon the premises of the contract manufacturer solely to conduct oversight and quality control activities. We believe this is the intent of proposed paragraph 4.5, but our experience indicates that an explicit statement to this effect may be needed to ensure its proper application in practice and prevent it from being read together with paragraph 10.1 to allege that such operations give rise to a permanent establishment for any principal that engages in regular oversight, even where those operations are conducted by independent third parties. Consistent with the changes recommended above to paragraph 4.2, we also recommend that paragraph 4.5 confirm explicitly that its discussion of contract manufacturers also applies to consignment or toll manufacturers and other suppliers.

* * *

In addition to the three major concerns discussed in detail above, TPWG members continue to have serious concerns about a number of other issues that the revised discussion draft does not address fully or, in some cases, at all. These include especially:

- The inconclusive guidance on the time required to create a permanent establishment in the context of recurrent activities or short-term business activities carried on exclusively within a State;

- The continuing reluctance of the Working Party to establish definitive time thresholds for creation of a permanent establishment in these and other circumstances;

- The suggestion that the phrase "to conclude contracts in the name of the enterprise" may be interpreted in the case of civil law commissionaires in a manner that is diametrically opposed to the well-documented history of OECD Article 5 guidance and to several European supreme court decisions already rendered; and

- The Working Party's failure to provide the guidance requested by business regarding the meaning of contract conclusion in other specified common commercial transactions, on the basis that the issues are factual in nature and that current guidance is sufficient.

TPWG members concur with the concerns expressed by BIAC on these points in its comments on the revised discussion draft.

* * *

The Treaty Policy Working Group appreciates the opportunity to provide recommendations on the revised discussion draft. We trust that our suggestions will be taken in the constructive spirit in which they are offered and hope that they will assist Working Party 1 in its further deliberations on these important issues.

Sincerely,

Carol A. Dunahoo

Gary D. Sprague

Rafic H. Barrage

cc: Pascal Saint-Amans, Director, CTPA
Jacques Sasseville, Head, Tax Treaty Unit, CTPA
Andrew Dawson, Chair, Working Party 1
Aart Roelofsen, Chair, Working Group 10